Summary

The Congressional Budget Office (CBO) projects that under current laws and policies, the federal budget will report a deficit of $337 billion in 2006 (see Summary Table 1). That estimate is somewhat higher than the $318 billion shortfall recorded in 2005 but about the same in comparison to the size of the nation's economy. At 2.6 percent of gross domestic product (GDP), this year's deficit would be slightly larger than the 2.3 percent average recorded since 1965.

Because of the statutory rules that govern baseline projections, CBO's current estimates omit a significant amount of spending that is likely to occur later this year. In particular, additional funding will probably be necessary in 2006 to pay for military activities in Iraq and Afghanistan and for flood insurance claims. If that funding is provided, CBO expects that outlays will grow by another $20 billion to $25 billion this year, resulting in a deficit in the vicinity of $360 billion, or about 2.8 percent of GDP.

CBO's baseline includes spending from the $50 billion that the Congress has appropriated this year for military activities in Iraq and Afghanistan, but more resources are likely to be necessary within a few months. The baseline also includes the effect of legislation dealing with disaster relief, flood insurance, and other programs that were funded in the aftermath of Hurricane Katrina and other storms. Such legislation will add an estimated $47 billion in outlays during 2006; hurricane-related tax relief will reduce revenues by an estimated $7 billion this year. But paying all claims expected under the federal flood insurance program could require a few billion dollars of additional funding for that program. Furthermore, the pending spending reconciliation act, if signed into law, would reduce the deficit by about $5 billion in 2006.

Under the assumptions incorporated in CBO's baseline—in particular, that various tax increases occur as scheduled and that discretionary spending grows at the rate of inflation—the budget deficit totals $270 billion (2.0 percent of GDP) in 2007 and continues to fall thereafter, essentially reaching balance in 2012. After that, the budget remains close to balance in the baseline, showing small surpluses ranging from $40 billion to $73 billion through 2016 (the end of the current projection period).

By statute, CBO's baseline must project the future paths of federal spending and revenues under current laws and policies. The baseline is therefore not intended to be a prediction of future budgetary outcomes; instead, it is meant to serve as a neutral benchmark that lawmakers can use to measure the effects of proposed changes to spending and taxes.

Underlying CBO's baseline projections is a forecast that the U.S. economy will continue growing at a healthy pace throughout calendar years 2006 and 2007. CBO forecasts that GDP will grow by 3.6 percent (in real, inflation-adjusted, terms) this year and by 3.4 percent next year. That rate of growth is projected to slow to an average of 3.1 percent from 2008 through 2011 and 2.6 percent from 2012 through 2016.

Over the longer term, the aging of the U.S. population combined with rapidly rising health care costs will put significant strains on the federal budget, which begin to be evident within the projection period. When the first members of the baby-boom generation reach age 62 in 2008, they will become eligible for Social Security benefits. As a result, the annual rate of growth of Social Security spending is expected to increase from about 4.8 percent in 2008 to 6.5 percent in 2016.

In addition, because the cost of health care is likely to continue rising rapidly, the annual rate of growth of Medicare spending is projected to increase from 7.4 percent in 2008 to about 8.9 percent in 2016. (Medicare

Summary Table 1.

CBO's Baseline Budget Outlook

	Actual 2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	Total, 2007-2011	Total, 2007-2016
							In Billions of Dollars							
Total Revenues	2,154	2,312	2,461	2,598	2,743	2,883	3,138	3,378	3,546	3,724	3,912	4,113	13,823	32,496
Total Outlays	2,472	2,649	2,732	2,857	2,984	3,105	3,252	3,340	3,506	3,666	3,839	4,046	14,930	33,328
Total Deficit (-) or Surplus	**-318**	**-337**	**-270**	**-259**	**-241**	**-222**	**-114**	**38**	**40**	**57**	**73**	**67**	**-1,107**	**-832**
On-budget	-494	-518	-466	-476	-474	-473	-380	-238	-243	-230	-218	-226	-2,269	-3,424
Off-budget[a]	175	181	196	217	233	250	266	276	283	288	291	293	1,162	2,592
Debt Held by the Public at the End of the Year	4,592	4,925	5,204	5,477	5,732	5,967	6,092	6,064	6,032	5,981	5,912	5,848	n.a.	n.a.
							As a Percentage of GDP							
Total Revenues	17.5	17.7	17.9	17.9	18.0	18.0	18.7	19.3	19.4	19.5	19.6	19.7	18.1	18.9
Total Outlays	20.1	20.3	19.8	19.7	19.5	19.4	19.4	19.1	19.1	19.2	19.2	19.4	19.6	19.4
Total Deficit (-) or Surplus	**-2.6**	**-2.6**	**-2.0**	**-1.8**	**-1.6**	**-1.4**	**-0.7**	**0.2**	**0.2**	**0.3**	**0.4**	**0.3**	**-1.4**	**-0.5**
Debt Held by the Public at the End of the Year	37.4	37.6	37.8	37.7	37.5	37.2	36.3	34.6	32.9	31.3	29.6	28.1	n.a.	n.a.
Memorandum:														
Gross Domestic Product (Billions of dollars)	12,293	13,082	13,781	14,508	15,264	16,021	16,768	17,524	18,311	19,121	19,963	20,839	76,343	172,101

Source: Congressional Budget Office.

Note: n.a. = not applicable.

a. Off-budget surpluses comprise surpluses in the Social Security trust funds as well as the net cash flow of the Postal Service.

spending is anticipated to rise by 17 percent this year and 14 percent in 2007 as the new prescription drug program gets under way.) Rapid growth is also projected for Medicaid spending—an average of 8.3 percent annually from 2008 to 2016. Under the assumptions in CBO's baseline, Social Security, Medicare, and Medicaid together will account for 56 percent of all federal spending by the end of the projection period (up from 43 percent in 2006). Measured as a share of the economy, spending for the three programs will equal 10.8 percent of GDP in 2016, up from 8.7 percent this year (see Summary Figure 1).

Beyond 2016, those trends are projected to continue. The percentage of the population age 65 or older will continue to increase (from 14 percent in 2016 to more than 19 percent in 2030). In addition, no evidence suggests that the growth of health care costs, which have risen faster than GDP over the past four decades, is likely to slow significantly in the future. As a result, spending for Social Security, Medicare, and Medicaid will exert pressures on the budget that economic growth alone is unlikely to alleviate. A substantial reduction in the growth of spending and perhaps a sizable increase in taxes as a share of the economy will be necessary for fiscal stability to be at all likely in the coming decades.[1]

The Budget Outlook

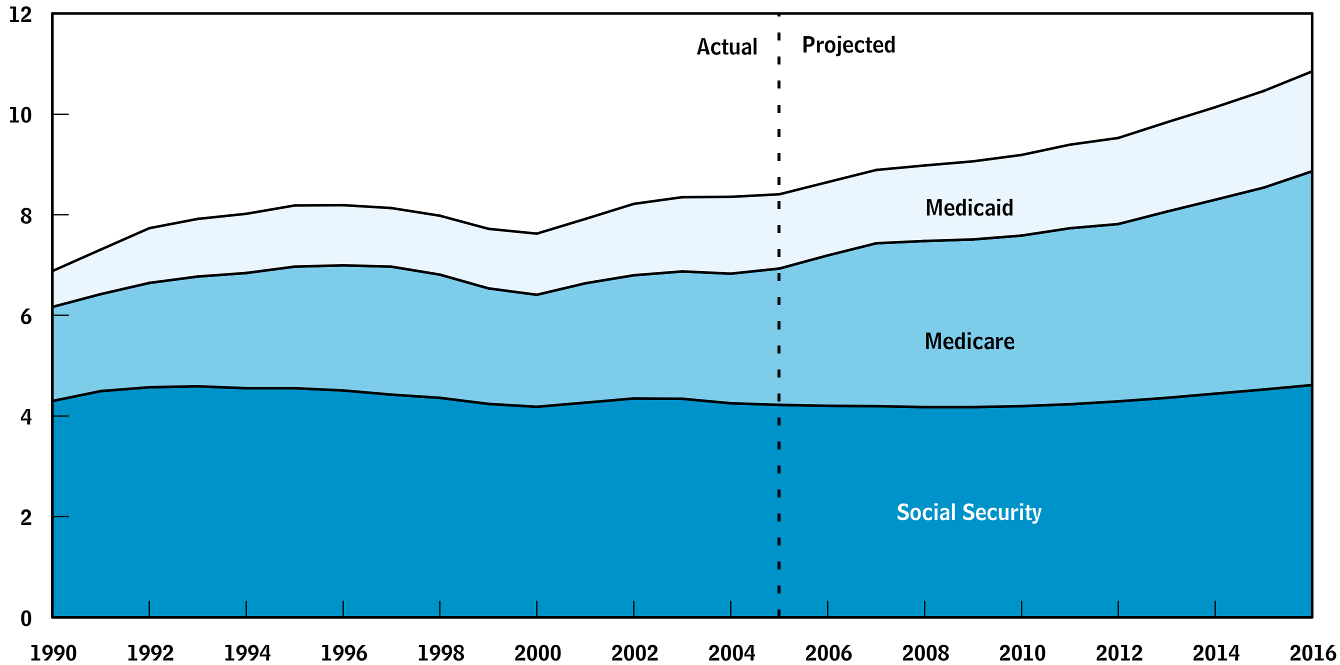
In CBO's current baseline, deficits decline gradually through 2010, as outlays increase at an average annual rate of 4.0 percent and revenues rise by 5.7 percent a year. Beyond 2010, spending related to the aging of the baby-boom generation raises projections of the average annual

1. For a detailed discussion of the long-term pressures facing the federal budget, see Congressional Budget Office, *The Long-Term Budget Outlook* (December 2005), *Updated Long-Term Projections for Social Security* (March 2005), and *The Outlook for Social Security* (June 2004).

Summary Figure 1.

Spending on Social Security, Medicare, and Medicaid, 1990 to 2016

(Percentage of gross domestic product)



Source: Congressional Budget Office.

growth of total outlays to 4.5 percent. However, revenues increase sharply in 2011 and 2012, growing by 8.9 percent and 7.6 percent, respectively—under the assumption that various tax increases occur as scheduled—and thereby bring the baseline projection of the budget near balance. Beyond 2012, revenues grow at about the same pace as outlays (roughly 5 percent a year), which keeps the bottom line showing small surpluses through 2016.

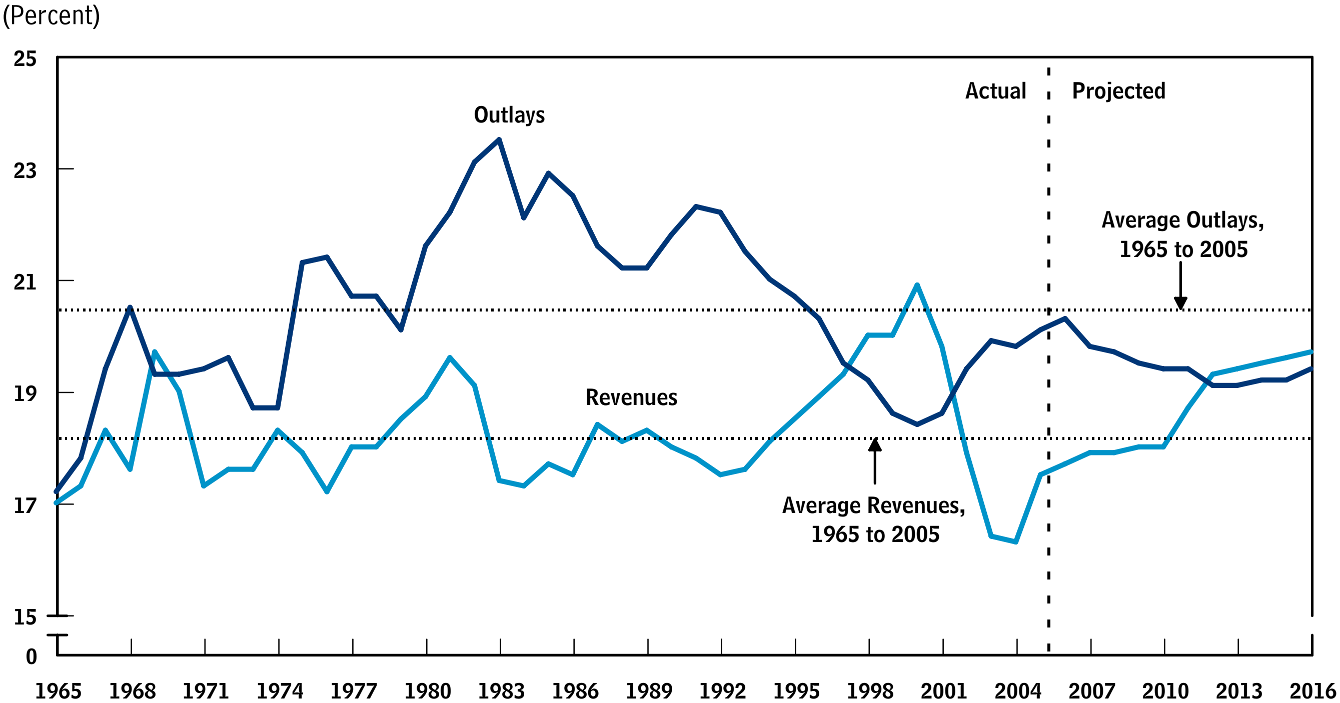
From 2007 through 2016, outlays are projected to remain between 19 percent and 20 percent of GDP under the assumptions in CBO's baseline (see Summary Figure 2). Mandatory spending (funding determined by laws other than annual appropriation acts) is projected to grow by 5.8 percent a year—faster than the economy as a whole. Discretionary appropriations, by contrast, are assumed simply to keep pace with inflation and, to a lesser extent, with wage growth. Thus, discretionary outlays are projected to increase by about 2.0 percent per year, on average—a pace less than half as fast as the projected rate of growth of nominal GDP and significantly slower than the average annual rate of 4.3 percent over the past 20 years.

According to CBO's projections, the structure of the tax code and rapid growth in retirement income will cause revenues to increase faster than the overall economy in each year of the projection period. In addition, CBO assumes—as rules for the baseline require—that the various tax provisions enacted in the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) and modified by the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA) and by the Working Families Tax Relief Act of 2004 (WFTRA) will expire as scheduled. Many of those provisions are set to expire at the end of December 2010, but some have an earlier expiration date. As a result, revenues as a percentage of GDP are projected to rise slightly through 2010, from 17.7 percent to 18.0 percent, and to increase more rapidly over the following two years, to 19.3 percent of GDP in 2012. By 2016, revenues are projected to reach 19.7 percent of GDP.

In CBO's baseline, accumulated federal debt held by the public (mainly in the form of Treasury securities sold in the capital markets) equals about 38 percent of GDP through 2009. Thereafter, projections of shrinking

Summary Figure 2.

Total Revenues and Outlays as a Percentage of Gross Domestic Product, 1965 to 2016



Source: Congressional Budget Office.

annual deficits and small surpluses diminish the government's anticipated borrowing needs, causing debt held by the public to decline to about 28 percent of GDP by 2016.

Relative to its previous baseline projections, which were published last August, CBO's estimate of the deficit for 2006 has increased by $22 billion and its projections of deficits in 2007 through 2015 have declined by an average of about $100 billion per year.[2] Those revisions reflect no fundamental change in the budgetary and economic environment. Indeed, when viewed as a percentage of the economy, they represent a difference of just 0.5 percent of GDP over the 2006-2015 period.

Most of the changes in CBO's new baseline stem from changes in economic factors that affect revenues and net interest, which cause the projection of the deficit for the 2006-2015 period to decline by a cumulative $736 billion. CBO's projected rates of economic growth are about the same as those underlying its previous baseline. However, higher inflation in the second half of calendar year 2005, combined with an upward revision to past measures of GDP, causes CBO to project higher levels of GDP and revenues throughout the projection period. In addition, CBO anticipates slightly lower interest rates from 2008 through 2015, reducing projected net interest outlays during that time.

Differences attributed to legislation also have reduced CBO's projection of the cumulative deficit, by $157 billion. The irregular timing and varying amounts of supplemental appropriations together with the treatment of such appropriations under the rules for the baseline explain most of that adjustment. Other, technical adjustments to the baseline have had a minimal effect—upward changes to both revenues ($151 billion) and outlays ($170 billion) nearly offset each other and increase the projected deficit by $19 billion over the 2006-2015 period.

2. See Congressional Budget Office, *The Budget and Economic Outlook: An Update* (August 2005).

The Economic Outlook

Economic activity had considerable momentum last year, some of which will carry into calendar year 2006. CBO forecasts that real GDP will grow by 3.6 percent this year and by 3.4 percent in 2007 (see Summary Table 2).

Despite an anticipated weakening in the housing market, economic growth will be driven by forces already set in motion—firms' continued need to expand productive capacity, solid increases in household income and wealth, and the lagged effects of declines in the value of the dollar since 2002. The housing market is expected to cool because potential buyers are likely to be deterred by concerns about the future growth of home prices and by higher interest rates. Business investment, however, will continue its recent strength because it has not yet fully caught up with the acceleration in the growth of demand in 2004 and 2005. The increases in employment and wages seen last year are also expected to continue, with the unemployment rate remaining near 5 percent, underpinning consumer spending. In addition, the lower value of the dollar combined with somewhat stronger economic growth abroad will cause exports to increase faster than imports (in real terms), CBO forecasts, bolstering the economy and keeping the U.S. trade deficit near its current level.

Along with healthy growth in demand and output, the growth of labor productivity (which usually slows in the later stages of economic expansions) will remain strong, CBO expects, though not as rapid as the extraordinary pace of the past five years. Overall inflation (as measured by the consumer price index) is likely to be lower this year than in 2005, when rising energy prices boosted it. According to CBO's forecast, the growth of the consumer price index will decline from the 3.4 percent recorded last year to 2.8 percent in 2006 and 2.2 percent in 2007. But the core rate of inflation—which excludes food and energy prices—will increase slightly in the near term, from 2.2 percent in 2005 and 2006 to 2.3 percent in 2007. Short-term interest rates are expected to rise in the first half of 2006, reaching 4.5 percent. Long-term interest rates are also anticipated to rise—to more than 5 percent, widening the spread between the rates on three-month Treasury bills and 10-year Treasury notes that existed in mid-January (when that spread was very small).

Hurricanes Katrina and Rita interrupted the economy's momentum temporarily. They reduced economic growth in the second half of 2005 by about 0.5 percentage points, in part by pushing up energy prices, which had already risen sharply since 2003. The impact of those natural disasters on the overall economy is expected to be relatively brief, however. This year, the recovery of energy production, rebuilding, and related activities are likely to boost growth by an amount similar to the reduction in 2005.

Beyond 2007, the pace of economic growth will probably slow somewhat. The main reason is that the labor force is projected to grow less quickly as members of the baby-boom generation begin to retire and as the scheduled expiration of various tax provisions in 2011 discourages work by raising marginal tax rates. Real GDP is projected to grow at an average annual rate of 3.1 percent between 2008 and 2011 and at 2.6 percent between 2012 and 2016. The rate of inflation is assumed to average 2.2 percent after 2007; and the unemployment rate, 5.2 percent. Interest rates on three-month and 10-year Treasury securities are projected to average 4.4 percent and 5.2 percent, respectively.

Summary Table 2.

CBO's Economic Projections for Calendar Years 2006 to 2016

	Estimated	Forecast		Projected Annual Average	
	2005	2006	2007	2008-2011	2012-2016
Nominal GDP (Billions of dollars)	12,494	13,262	13,959	16,954 [a]	21,064 [b]
Nominal GDP (Percentage change)	6.5	6.1	5.3	5.0	4.4
Real GDP (Percentage change)	3.6	3.6	3.4	3.1	2.6
GDP Price Index (Percentage change)	2.7	2.4	1.8	1.8	1.8
Consumer Price Index[c] (Percentage change)	3.4	2.8	2.2	2.2	2.2
Core Consumer Price Index[d] (Percentage change)	2.2	2.2	2.3	2.2	2.2
Unemployment Rate (Percent)	5.1	5.0	5.0	5.2	5.2
Three-Month Treasury Bill Rate (Percent)	3.2	4.5	4.5	4.4	4.4
Ten-Year Treasury Note Rate (Percent)	4.3	5.1	5.2	5.2	5.2

Sources: Congressional Budget Office; Department of Commerce, Bureau of Economic Analysis; Department of Labor, Bureau of Labor Statistics; Federal Reserve Board.

Notes: Percentage changes are year over year.

Year-by-year economic projections for calendar years 2006 to 2016 appear in Appendix E.

a. Level in 2011.

b. Level in 2016.

c. The consumer price index for all urban consumers.

d. The consumer price index for all urban consumers excluding prices for food and energy.